Moody's Investors Service

Global Credit Research
Rating Action
18 DEC 2006

Rating Action: **American Capital Strategies, Ltd.**

Moody's Assigns Baa2 Rating to American Capital Strategies

New York, December 18, 2006 -- Moody's Investors Service assigned a Baa2 long-term issuer rating to American Capital Strategies, Ltd (ACAS). The outlook for the rating is stable.

The issuer rating reflects ACAS's position as the largest firm (by total assets) regulated by the SEC as a Business Development Company (BDC). ACAS invests in private, middle-market companies by providing senior debt, subordinated debt, and equity. Since its IPO in 1997, ACAS has demonstrated strong operating performance through various economic cycles.

Moody's said that ACAS's diversified investment portfolio (both by geography and business sector) provides a safeguard in the event of a regional economic or business sector performance downturn. It will be important for ACAS to maintain this diversity in its portfolio. Moody's expects that this will be the case given that the company plans on specializing in additional industry sectors.

Moody's also noted ACAS's commitment to thorough due-diligence on its investments as a ratings strength. Through its Finance Accounting Compliance Team (FACT), ACAS has invested substantial resources to provide senior management with both pre and post investment due diligence. As ACAS continues to expand and invest in a greater number of portfolio companies, it will be important for FACT to grow in concert with the investment base.

From a financial metrics perspective, ACAS is well positioned, particularly due to the company's substantial equity base. BDC regulations require ACAS to effectively maintain leverage below one to one (debt to equity), which is significant. ACAS's sizeable equity cushion provides its debt holders with considerable protection in the event portfolio valuations decline. ACAS does manage this metric closely to the requirement; however, the use of its equity forward program provides some flexibility and potential relief, although the amount of the equity forward is likely insufficient to cover an extensive portfolio decline.

Regarding ACAS's profitability, Moody's recognized that the company's return on average managed assets (defined as net investment income plus net realized gains as a percentage of average managed assets) has produced strong results in recent years. The ability of the company to maintain these returns in an economic downturn will be key in demonstrating its expertise in investment selection and operations.

ACAS has limited internal capital generation given its requirement to pay out substantial dividends. In order to grow it needs to frequently tap the public equity market. Therefore, it is important for the company to maintain investor confidence and a solid equity price. Moody's noted that the company earns a significant amount of interest and fee income from its large loan portfolio, which to date, has been adequate to cover the company's substantial dividend. This is a strength because the company has not needed to rely on realized gains from its equity investment portfolio -- that tend are more variable from quarter to quarter -- and asset management earnings from its subsidiaries to support dividend payments and dividend growth.

ACAS has a solid liquidity profile, given the extended maturities on its debt obligations and capacity on its revolving credit facilities. The company also generates significant cash flow on its large loan portfolio, which provides strong interest coverage metrics. Finally, the company is focusing more on its ability to originate and service assets, while transferring the underlying asset risk to third parties. While ACAS's managed-only versus owned assets is still relatively small, positive execution on this plan will further enhance liquidity and profitability through increased fee income.

Moody's said that there are a number of risks that balance these positive attributes. First, ACAS has demonstrated a substantial increase in its portfolio as the company has grown both debt and equity investments, particularly during the last few years. Moody's stated that this growth has come at a time when there has been very limited stress in the US economy and in corporate credit generally. While growth to date appears well managed, there is a risk that the portfolio will not perform as anticipated when conditions weaken and that the firm's resources could become strained as expansion continues. Furthermore, ACAS is entering additional industry segments for investments and pursuing a strategy of increasing its focus on managing assets owned by outside parties. These initiatives require specific expertise and retention of key personnel.

Moody's will actively monitor the company's portfolio performance as well as the continued development of its infrastructure as it continues its path of substantial growth. Portfolio seasoning and testing through a more challenging credit environment will be necessary prior to any upward rating potential.

ACAS invests debt and equity in middle market, private companies. Due to the nature of these investments, portfolio valuation on its equity investments is subjective and difficult. The company's historical results reflect conservative valuations on its equity investments; however, due to ACAS's strategy of managing leverage near BDC limits, there is a risk that if valuations were overestimated, the company could violate BDC guidelines and impair investor confidence.

As touched upon above, ACAS's status as a Regulated Investment Company requires the company to distribute 90% of ordinary taxable income to shareholders in the form of a dividend. This requires ACAS to maintain high investor confidence, because the company must frequently tap the capital markets for growth. This limit on the company's financial flexibility is a rating constraint which is also seen in the REIT universe. Moody's recognizes that ACAS's ability to cover and grow its dividend with ordinary income as opposed to cash (or other liquid assets) or long-term capital gains mitigates this risk to some extent.

Finally, there is a risk that greater competition could impact portfolio yields or lead to adverse investment selection as more companies enter the middle market lending and buyout business. ACAS's ability to differentiate itself from other market participants with its product offerings and operations expertise is also significant to the rating.

What Could Change the Rating -- UP

The rating could go up if ACAS demonstrates continued strong operating performance through a credit cycle while meeting its considerable growth objectives without stress on the resources of the company or impairment to the franchise. Moreover, a continued shift to more consistent streams of income (asset management fees) could improve the rating, although this transformation is still in the early stages and considerable challenges remain before this is a ratings benefit.

What Could Change the Rating -- DOWN

The rating could decline if ACAS's portfolio performance materially weakens, if it has a substantial impairment on its investment portfolio, or if it experiences a protracted reduction in realized yields due to greater competition. Although not expected, a significant change in the company's capital structure that pressures the BDC guideline covenants could also lead to a lower rating. In addition, failure to increase and retain key personnel to accommodate the expected growth objectives could also pressure the rating.

The following rating was assigned:

Long-Term Issuer RatingBaa2

American Capital Strategies, Ltd. (NASDAQ: ACAS) is headquartered in Bethesda, Maryland, and reported assets of approximately $7.9 billion at September 30, 2006.

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